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C O N F I D E N T I A L SECTION 01 OF 02 KYIV 001531

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SUBJECT: IMF STOCKTAKING

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Classified By: Economic Counselor Edward Kaska for Reasons 1.4 (b) and (d)

¶1. (SBU) Summary. IMF's Resident Representative in Ukraine, briefing on mission director Ceyla Pazarbasioglu's "stocktaking" visit to Kyiv, commented that he has doubts about Ukraine's intention to live up to its commitments and expressed concern over Ukraine's ability meet its budget obligations past September. He observed that bank recapitalizations were proceeding relatively well and that tax and pension reform committees had been formed and were meeting. However, the independence of the central bank and its ability to withstand pressure to monetize budget shortfalls remained uncertain. As a result of unmet commitments, the IMF is considering where to draw the line as it approaches negotiations for the fourth tranche. End Summary.

¶2. (SBU) Max Alier, the IMF's Resident Representative in Ukraine, briefed the US, UK, French, German, Canadian, and European Commission diplomatic missions in Kyiv on Saturday afternoon. Alier reported on the September 1 - 4 visit of an IMF team to Kyiv to assess the state of the IMF's standby program in Ukraine. The IMF visiting team was led by Ceyla Pazarbasioglu who has headed the previous IMF Mission visits to Ukraine.

¶3. (SBU) Alier stressed that the staff visit was not a negotiation but what he called a "stocktaking" of the IMF program and preparations for a late October visit to Kyiv, when a formal IMF review mission and negotiations concerning a fourth IMF tranche will occur. Alier stated that the past week of meetings between the IMF and GOU (from the "PM on down") had been intense and had not gotten off to a good start when a Ukrainian paper on August 31 published an interview Alier had given to it earlier on August 7. Alier in his interview comments had noted that the IMF would not be a party to an irresponsible GOU budget.

¶4. (SBU) Gas prices: The first "bad news" from the visit was the GOU's failure to implement a commitment to raise gas prices for households by 20% on September 1. The GOU claimed a failure to win trade union approval of the increase as required by "law" and a court injunction against the NERC prevented the increase. GOU officials said they planned to implement a promised 20% increase on energy producers on October 1 which does not face the same legal hurdles. Alier could not reconcile what GOU officials had told him this past week about gas prices and PM Tymoshenko's earlier statement in western Ukraine that there would not be a gas price increase before January 2010 elections. Alier volunteered that if the GOU really wanted to do something that it seemed always to find a way to do it, but he could envision a situation where the barriers to a price increase on household

gas could drag on "forever".

15. (SBU) Fiscal Situation: Alier noted the GOU fiscal situation is "very tight" and "they cannot make it on their own," and as such the GOU must get a fourth IMF tranche or find another funding source. The recent payment for August gas had come from a VAT refund due Naftohaz, which in turn used it to pay Gazprom. Alier said September will be "tight" and "we'll see what they do in October". He expects Ukraine will "close the tap" and import little Russian gas in September, and that October will be a very difficult month for the GOU, as a fourth tranche of \$3.8 billion, if approved, can only be disbursed in mid-November. Alier noted that negotiations over a fourth tranche, which the GOU wants to be used solely for budget support, will be difficult. Alier speculated that Tymoshenko has been negotiating with Putin to win Russian financial aid, and that she would "care less" about the IMF program if she could find bilateral funds to fund the budget.

16. (SBU) 2010 Budget: Alier indicated it is too soon to review the GOU's 2010 budget. The IMF wants the GOU to produce a 2010 budget with no more than a 3.0% budget deficit (4% with Naftohaz subsidies included), but the GOU has been indicating a 3.75% (before Naftohaz subsidies) deficit is in order. Alier added that the GOU's revenue projection for 2010 was "quite large" and that the numbers would get closer scrutiny from an IMF budget team that will visit Ukraine this week. The Cabinet of Ministers faces a September 15 deadline to submit a budget to the Rada (parliament).

17. (SBU) Bank Recapitalization: Alier expects that bank

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recapitalization will be completed by the end of 2009 and that the 2010 budget will not have to take account of funds for bank recapitalization. He expects the resolution process at UkrpromBank would be completed first, which is a less complicated situation than that at Nadra Bank. Alier added the NBU will handle small problem banks and that these were not really recapitalizations, as the banks will be merged or liquidated.

18. (SBU) NBU Independence: Alier noted the NBU, which falls under President Yushchenko's purview, thus far was "not cooperating fully with monetizations." The NBU had not implemented a recently passed law requiring it to provide UAH 10 billion to fund the hosting of the Euro 2012 soccer tournament, and the NBU had not delivered on an alleged deal between PM Tymoshenko and NBU Head Stehlmakh to monetize the repayment of Naftohaz bonds. Alier believes that NBU monetization of the budget gap is "not a high possibility," but whether the NBU can ultimately resist pressure to monetize the budget gap remains to be seen. Alier stated it will be a matter of public relations, claiming that if the GOU could not pay wages in the autumn it would blame the NBU, thus placing the NBU in the position of defending its policies. Alier noted the Rada had failed to pass legislation ensuring the NBU's independence, a condition of the IMF program, and that GOU-NBU tensions were "running high." He also observed Stehlmakh was "on vacation" again and apparently not involved in day to day NBU operations.

19. (SBU) Exchange Rate: Alier said "liquidity injections" and "panic in the population" were driving recent hryvnia depreciation. Repetition by television stations (which Alier characterized as owned by oligarchs with export oriented businesses that would welcome further depreciation) of stories about an autumnal decline of the hryvnia could become a self fulfilling prophecy. Alier noted the NBU's official exchange rate "makes no sense" and does not comply with the IMF condition that it be kept within 2% of the market rate, and the NBU was facing the issue of "how much do you let it go" in terms of UAH depreciation.

110. (SBU) Budget Code: The GOU, according to Alier, is

trying to "sneak by" again a new budget code that would allow more funds to be sent to the regions. The IMF is not opposed to decentralization, but the proposal is not the way to do it. Tymoshenko was meeting with 12,000 local government officials this week.

¶11. (SBU) Bright Spots: Alier said that committees to work on pension reform and tax reform are formed and were meeting.

However, he did not expect any substance out of the reform committees before the January 2010 elections. He also indicated that the GOU had agreed to a "monitoring committee" where the IMF meets all with all parts of the government affected by an issue (the committee membership changes with the issue) and that in fact the commission had met with the IMF team during their visit. Alier expressed the hope that the monitoring committee would begin regular biweekly meetings with the IMF team.

¶12. (SBU) Istanbul Meetings: Alier sees no serious negotiations between GOU and IMF in Istanbul, as relevant staff (including Pazarbasioglu and Alier) will not be there.

¶13. (SBU) The Executive Board: Pazarbasioglu will consult with IMF management in Washington, and several Executive Directors already have requested meetings with her. Alier believes a "decision" regarding the direction of the IMF program in Ukraine cannot wait until November and he expects IMF management will "be reaching out to capitals" and that the IMF Mission to Ukraine will soon "get some parameters" from Washington. Alier noted that a decision regarding "where you draw the red line" is needed from Washington, and then added that when the IMF leaves a country it does not formally announce that it is walking out.

¶14. (C) Comment: In the run-up to Ukraine's January presidential election, it is difficult to envision PM Tymoshenko making the hard, necessary reforms to which she has previously committed, even if the IMF threatens to walk away from future disbursements. As Alier alluded, if negotiations for the IMF's fourth tranche prove to be difficult, PM Tymoshenko will attempt to secure other funding sources -- including bilateral support from Russia -- as well as pressure the NBU to monetize any budget shortfall. Such actions by Tymoshenko would be a significant setback for the reform process in Ukraine. End Comment.
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